NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Third Quarter of 2004 through the Fourth Quarter of 2008

The U.S. economy is forecast to make steady progress over the next few years, but fall short of its potential. This can be seen in the output and jobs forecasts. Specifcally, real output is expected to average about 3.0% annual growth after 2004. While this is a welcome change from the lackluster growth of 2001 and 2002, it is below the estimated potential GDP growth of 3.5%. The sub-potential growth is also evident in the employment numbers. This year's projected 1.7% increase is the high-water mark for the forecast period. After this year, national nonfarm employment should expand at about 1.0% annually. While any growth is a relief from the job drought of 2001-2003, the forecasted pace of job creation will not be fast enough to absorb all the expanding labor pool. As a result, after falling initially, the U.S. civilian unemployment rate is expected to increase in the latter part of the forecast and fail to return to full employment.

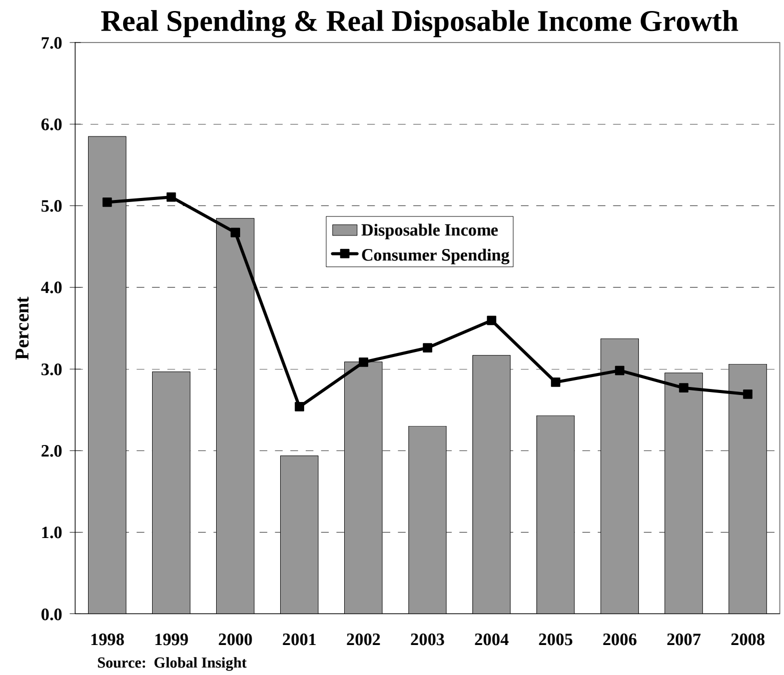
It should be obvious oil prices have been a major determinant of the economy's performance over the past year. Unfortunately, it has been harder to determine the level of oil prices. A look at Global Insight's oil price predictions illustrates this point. At the beginning of 2004, it was assumed the price of West Texas Intermediate crude would be $28 per barrel in 2004 and $26 per barrel in 2005. Several surges later, these price forecasts have been raised to $42 for 2004 and $46 for 2005—upward increases of $14 and $20 respectively.

These huge oil prices increases may have subdued the U.S. economic expansion, but they have not stopped it. The forecast for real U.S. GDP growth for 2004 has been revised downwards from 4.7% in January 2004 to 4.4% in November 2004. Likewise, real GDP growth in 2005 has been scaled back from 4.0% in the beginning of the year to 3.2% near the end of the year. What is surprising is not how much the output forecasts have been reduced, but how little. Based on historical precedent, the casual observer would conclude oil price increases of the size discussed here would send the U.S. economy into a tailspin. But they have not because the U.S. economy is less dependent on oil than in the 1970s and 1980s.

One issue that moved to the front burner was the nation's swelling current account deficit. Although it had been ignored for years, this imbalance was noticed when it began to put downward pressure on the U.S. dollar. The falling dollar has its good and bad points. The major good point is it makes American goods and services more affordable in the global market, and this should help shrink the lopsided global trade picture. Unfortunately, the dollars decline alone will not be sufficient to fix the trade imbalance. First, for the last several years many foreign economies have benefited from the strong dollar, which allowed their companies to export themselves to prosperity by selling to the U.S., but doing little to stimulate demand in their own countries. In addition, since China pegs its currency to the U.S. dollar, it has not been affected by recent exchange rate changes. Foreign companies may also be willing to absorb losses from exchange rate fluctuations in order to maintain their markets shares. These factors also help explain why inflation remains benign in spite of the falling dollar, which is usually inflationary.

The relatively slow job growth should also contain inflation because forthcoming compensation gains should be modest. Indeed, the U.S. civilian unemployment rate is expected to remain above the level at which inflationary fires will be rekindled. Thus, should the economy grow faster than expected, it should be able to do so without igniting rapid inflation.

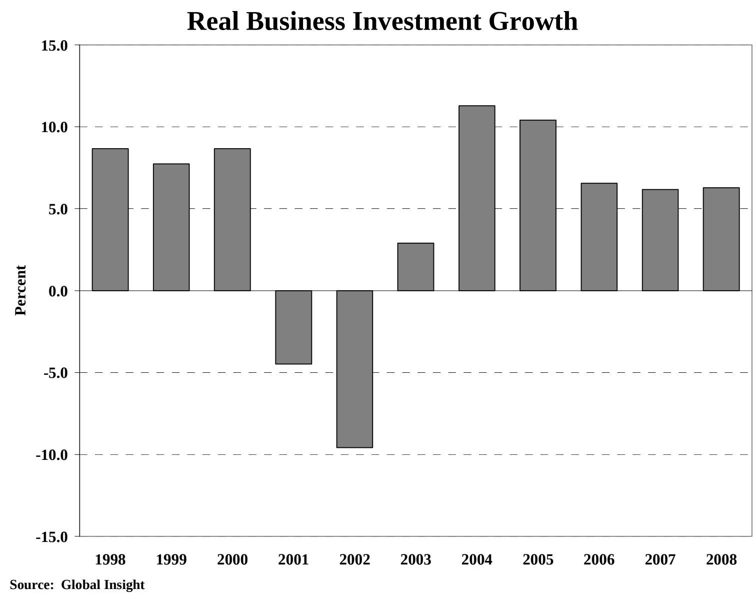
SELECTED NATIONAL ECONOMIC INDICATORS



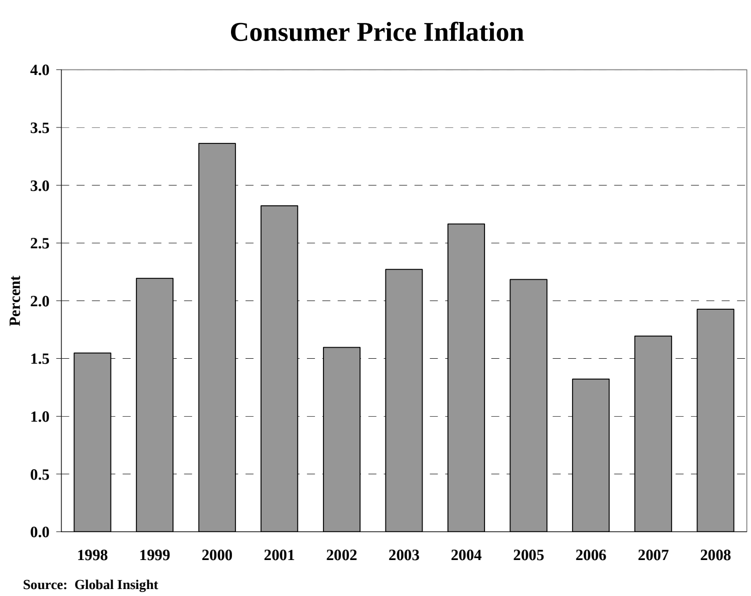
Consumer Spending: The economy's consumer sector is expected to transition from a leading role to a supporting role during the forecast period. This will be a notable change because consumer spending kept the U.S. economy afloat while other sectors foundered. Real consumption spending grew faster than real GDP in every year from 1998 to 2003. A close examination shows consumer spending was an important positive influence that restrained the severity of the last recession. Real consumer spending growth slowed to 2.5% in 2001, but has accelerated in each year since. Several factors account for the strong post-recession spending. They include low interest rates, the strong housing market, and temporary federal tax cuts. However, in the near term, consumer spending will need to shift to another fuel source because interest rates are expected to rise, the housing market is forecast to cool, and no major income tax cuts are anticipated. Absent these factors, consumer spending will become more dependent on the recovering job market. As a result, real spending is expected to grow more in line with real disposable income over the next few years than it has in the last few years. As the accompanying chart shows, since 1999 real consumer spending has generally grown faster than real personal income. One of the ways consumers financed this shopping spree was to curtail personal savings. The personal savings rate crossed a notable threshold in the third quarter of 2004 by falling to its lowest level since quarterly data were collected since 1947. From 1946 to 1992, the savings rate averaged 8.5% with no discernable trend. It plummeted from 1993 through 1999 before stabilizing near 2% during 2000 through 2002. After that it resumed its fall. Fluctuations in the savings rate can be explained by the wealth effect, interest rates, and credit availability. The decline in savings during the 1990s coincided with rising household net worth as stock markets boomed and home values appreciated. Households spent some of this new wealth, reducing the savings rate. The extension of credit also encouraged spending by low-income households. When the stock market collapsed in 2000-02, people were expected to save more of their incomes to rebuild depleted financial assets. Instead, declining interest rates sparked a wave of mortgage refinancing in which homeowners liquidated some of their home equity gains. In some cases, savings from lower mortgage payments provided another funding source for spending. The U.S. personal savings rate is currently at 0.4% of disposable income. The savings rate is expected to post a gradual recovery over the forecast period, but will not reach its pre-2001 level. The low savings rate is a concern because it could hamper long-term economic growth. Lower personal savings reduces the supply of funds available for capital formation. This pushes up long-term interest rates, which raises the cost of borrowing. The higher borrowing costs lower capital investment, and this limits potential long-term GDP growth. Real consumer spending is expected to increase 3.6% in 2004, 2.8% in 2005, 3.0% in 2006, 2.8% in 2007, and 2.7% in 2008. In comparison, real disposable income should rise 3.2% in 2004, 2.4% in 2005, 3.4% in 2006, 3.0% in 2007, and 3.1% in 2008.

Business Investment: Business investment has witnessed an interesting turnaround lately. Usually, spending on high-tech items grows faster than investment in low-tech items. But this has been reversed. Spending on high-tech items has grown slower than the investment on low-tech items.

Specifically, spending on equipment and software posted double-digit annualized growth for the fifth time in six quarters during the third quarter of 2004. And for the second quarter in a row, the low-tech categories outperformed the high-tech ones. Excluding equipment and software, nominal spending jumped 27% in the third quarter. Overall, nominal spending on equipment and software grew 13.2%. It was kept down by weak spending on equipment that rose a meager 1.6%. Several explanations have been offered for the abrupt slowdown in high-tech equipment spending. One theory is high-tech recovered much earlier than other equipment categories, so its go-go years have passed. The Wall Street Journal suggested the surge in high-tech equipment spending came from companies catching-up on delayed upgrades. Now that these companies are caught up, spending is slowing. This forecast assumes the recent slowdown was merely a hiccup, and that spending should rebound beginning with the fourth quarter of 2004. Another interesting change in the equipment category is computer prices are not falling as quickly as they once did. This raises two important questions. First, why have computer price declines slowed? Second, how will this change impact productivity growth? To answer the first question, the rate of technological change appeared to move at light speed during the 1990s. However, in recent years, perhaps because the profits from innovation are now understood to be smaller than once thought, the rate of innovation has slowed. As a result, price reductions have decelerated. The short answer to the second question is productivity will slow. Over the past 50 years productivity growth averaged 2.2% per year. Over the past four years, it has averaged nearly 4% annual growth. Over the forecast period, productivity will slow to about 2.5% per year. This slowdown is partially the result of the slower investment in equipment.



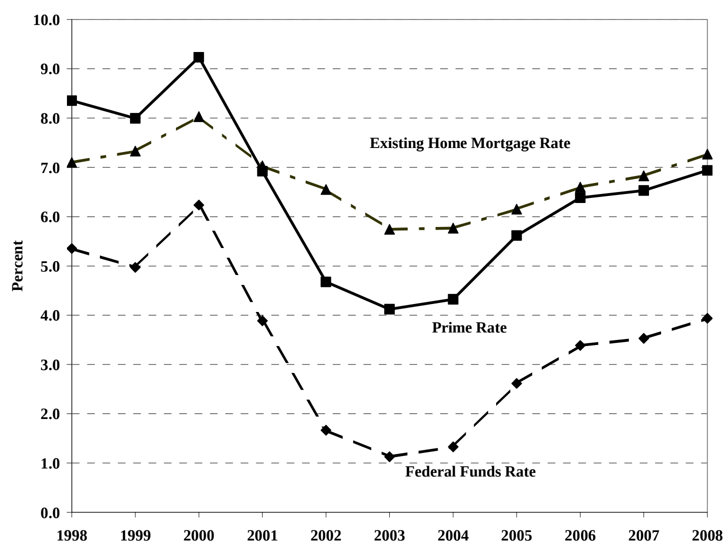
Inflation: Inflation is expected to remain benign over the forecast period. Despite being assailed by surging oil prices and the falling dollar, overall consumer price inflation remained under 3.0% in 2004. In the fall of 2004 oil prices topped $50 per barrel, which pushed the energy commodities component of the consumer price index (CPI) to rise by over 18% in 2004. However, little of this spilled over into the overall CPI, which advanced 2.7% in 2004. While this is the highest inflation in four years, it does not come close to matching the inflation experienced during the 1970s. For example, in 1979 the energy component of CPI soared by 34% and the over CPI jumped 11%. Interestingly, the energy component of CPI grew slower in 1990 than in 2004, yet overall inflation was 2.7% in 2004 compared to 5.4% in 1990. Energy prices have less of an impact on overall inflation than in the past because the U.S. economy is more energy



efficient then it was in the past. Part of this is the result of technological changes and some of it reflects structural changes in the economy. The U.S. economy continues to move from a goods-producing economy to a services-producing economy. The latter simply uses less energy per unit of output than the former. Another potential source of inflation is the falling dollar. As the dollar value falls, it makes imported goods relatively more expensive for Americans to purchase imported goods. So far, the dollar's fall does not seem to be boosting inflation. There are a couple of explanations why inflation remains well behaved while the dollar falls. First, for most exporting nations, the U.S. market is too important to abandon. By raising prices, they risk losing their hard-won share of the U.S. market. Instead, they have resisted raising prices and absorbed losses caused by the falling dollar in order to remain competitive in the world's most lucrative market. Second, China is a major exporter of consumer goods into the U.S. market. Chinese goods are largely insulated from changes in the dollar's value because the Chinese currency is pegged to the dollar. In essence, the exchange rate between the countries' currencies remains constant, so there is no need for Chinese companies to change their prices. Over time, oil prices and exchange rates should be less of a threat to inflation. Oil prices began moving down in the winter of 2004 and the dollar is expected to gradually decline. Under these conditions, the primary determinant of inflation is employment costs. These costs are largely dictated by labor market conditions. The anticipation of slow job growth suggests employee compensation, and thus, employment costs will rise slowly. The forecast calls for wages and salaries to advance just over 3% per year and benefit costs to increase between 4% and 5%. The major wild card in the benefits forecast is health insurance costs. According to the forecast, this important component of total employee compensation should grow slower over the forecast period. However, history has shown this component is capable of escalating quickly. Consumer price inflation is forecast to rise 2.2% in 2005, 1.3% in 2006, 1.7% in 2007, and 1.9% in 2008.

Financial: The Federal Reserve continues its plan to raise interest rates to a more normal level. The central bank's most recent step came on December 14, 2004, when it raised its federal funds rate by 25 basis points for the fifth time since May 2004. As a result, the bellwether federal funds rate was 2.25% at the end of 2004. The December 2004 move was the most difficult change of the string of increases to predict. This is because Federal Reserve statements made after recent increases have hinted the bank would delay further increases if it felt the economy was in danger of stalling. In addition, some bank officials have voiced concerns about the economy's fortitude and its vulnerability to high oil prices. These were also concerns before the Federal Reserve raised its short-term funds rate in November 2004. But signs the economy remained on solid footing were evident back then, and this helped convince the central bank to continue raising interest rates. Two key factors influencing this move were the increase of over 300,000 nonfarm jobs in October 2004 and falling oil prices. The Federal Reserve usually increases interest rates to cool the economy in order to keep inflation under control. However, the Federal Reserve's recent increases are hard to tie to inflation because prices have been relatively well behaved. Instead, it seems to be moving to a more normal level of interest rates. A bit of history explains the Federal Reserve's recent action. At the end of 2000, the federal funds rate was 6.5%. However, fears of the economy's health caused the central bank to lower interest rates in order to keep the economy moving forward. The federal funds

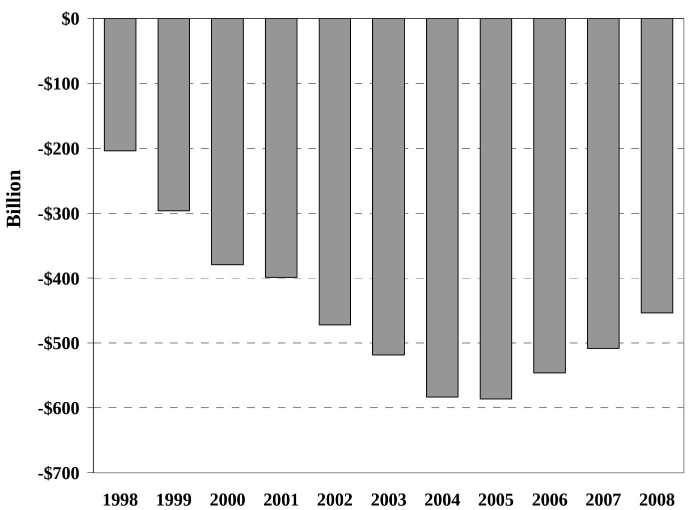
Selected Interest Rates



Source: Global Insight

rate fell to its nadir of 1.0% in June 2003 and remained at that level for about a year. This caused the real interest rate (federal funds rate less inflation) to become negative, which boosted the weak economy. The economy has grown since then and is better able to stand on its own, so the need for policy driven stimulation is unnecessary. In addition, with the federal funds rate at 1.0%, the U.S. central bank was at risk of losing one of its most important policy tools because it cannot lower rates below 0%. With the federal funds rate 2.25%, the central bank has expanded its options. At 2.25%, the federal funds rate is at a level where the real interest rate is near zero, so the Federal Reserve can stretch out its interest rate increases. The Federal Reserve will not remain neutral, but it is expected to raise the federal funds rate gradually to 4.25% by the end of 2008. Interestingly, the Federal Reserve has done little to prop up the dollar. Theoretically, the Federal Reserve could raise rates in order to increase the attractiveness of holding dollar-denominated assets, which would boost the demand for dollars, which would raise its value versus other currencies. But the gradual interest rate increases suggest the Federal Reserve's attention will remain focused on the economy and inflation.

Real U.S. Trade Deficit

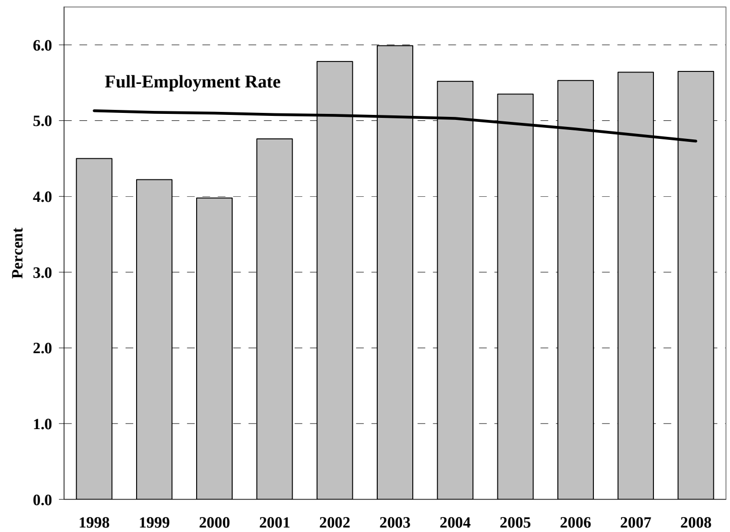


Source: Global Insight

International: Recently, doubts about the current strength of world economic growth have moved to center stage. In addition, record-breaking oil prices raised uncertainty about whether above–trend economic growth rates can be extended through 2005. While surging oil prices represent a temporary headwind to global economic growth, their negative impacts will be limited by the global economy's reduced oil intensity compared with the 1970s and 1980s. The reduced inflationary impact of oil prices provides central banks with more maneuvering room than in the previous oil crises. As a result, the world economy's recent setbacks are temporary and growth should remain strong enough for the current cyclical recovery to continue. North America and Asia/Pacific, which have led the way with strong rebounds since the end of the Iraq crises, should maintain their leads through the first half of 2005, and the economies of either region should continue to benefit from higher global trade volumes and improving terms of trade. Another important factor is the U.S. dollar's recent slide. The drop in the greenback should make American products less expensive relative to their foreign competitors, which, in turn, should boost U.S. exports. After dropping by 7.8% in 2004 alone, the dollar is expected to decline gradually over the forecast period, so it is 8.3% lower in 2008 compared to 2004. Eventually, this should help shrink, but not erase, the nation's enormous trade imbalance. Other factors will work to keep the U.S. trade balance lopsided. First, some trade partners who are quick to criticize the U.S. trade deficit are the very ones who have benefited the most from it. In recent years, the U.S. has carried global economic growth. Foreign countries facing lackluster demand at home have attempted to export themselves to prosperity by selling to the U.S. Second, the worldwide excess of manufacturing capacity will cause foreign competitors to think twice about raising prices that would threaten their U.S. market share. Third, China, one of the nation's largest trading partners, pegs its currency to the dollar, so anticipated declines will have little impact on its imports into the U.S. or how much it purchase from the U.S. Fourth, exporting countries benefit from a strong dollar, and are likely to intervene to keep it from going into a freefall. It is estimated U.S. real net exports was $583.3 billion in 2004, which is 12.5% higher than the previous year. It is expected to rise just slightly to $586.2 billion in 2005 and shrink in the remaining years of the forecast.

Employment: National nonfarm employment grew in 2004 after a three-year hiatus. From 2000 to 2003, the U.S. economy shed over 1.8 million jobs. Unfortunately, the nation's manufacturing sectoring took an even bigger hit by losing nearly 2.8 million jobs over this same period. It has been estimated another 150,000 manufacturing jobs were lost in 2004. Despite the manufacturing sector's losses, overall nonfarm employment managed to expand a modest 1.0% in 2004. This long-awaited gain results from an unusual monthly job-growth pattern. Instead of growing steadily, employment growth in 2004 has displayed a pattern that consists of a string of disappointing months followed by months of outstanding job growth. For example, after strong month-to-month gains in March, April, and May, there was unspectacular nonfarm employment growth through most of the summer. This was followed by a strong October, when over 300,00 jobs were added. November brought an additional 112,000 jobs. During the first 11 months of 2004 an average of over 185,000 jobs per month have been added to the U.S. economy. The next year promises to be even better, with a projected 1.7% increase over 2004. It should also be pointed out U.S. nonfarm employment should top its 2001 peak in 2005. The return to job expansion is especially well timed. Up until recently, overall economic growth has been policy driven. An accommodative monetary policy and a generous fiscal policy kept the economy moving ahead. Job growth has to return as an important growth engine just as policies are becoming less generous. Nonfarm employment is expected to grow slower after 2005, averaging about 1% per year. The non-manufacturing component will enjoy most of the growth over this period. Manufacturing employment is anticipated to post meager gains in 2005 and 2006, but these increases will not come close to replacing the jobs lost by this beleaguered sector since 2000. From 2005 to 2008, about 105,000 nonfarm jobs should be added per month. At that pace, the job market will not grow fast enough to keep up with the expanding labor force. This can be seen in the unemployment data. After peaking at 6% in 2003, the U.S. civilian unemployment rate improved to 5.5% in 2004 and should move down to 5.4% in 2005. However, it is expected to gradually rise thereafter, reaching 5.7% in 2008.

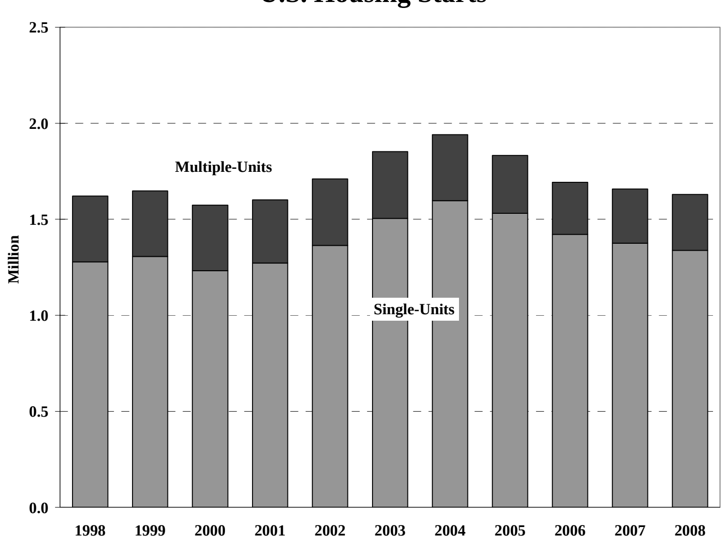
U.S. Civilian Unemployment Rate



Source: Global Insight

Housing: The nation's housing industry is expected to gradually slow after enjoying a banner year in 2004. The housing sector has been a pleasant surprise during the recovery. Economists have more than once issued warnings of the housing sector's imminent retreat only to see it set new records. This can be seen in both the housing starts and housing sales data. After falling to 1.57 million units in 2000, the number of housing starts has increased in every year thereafter. In 2003, housing starts topped 1.8 million units for the first time since 1986. This milestone will be passed in 2004, when housing starts should grow

U.S. Housing Starts



Source: Global Insight

comfortably above 1.9 million units—its strongest showing since 1978. The performance of housing sales has been even more impressive. Fueled by low mortgage interest rates, sales of existing homes rose from five million units in 1998 to over six million units in 2003. Given the major role low interest rates have played in bolstering the housing sector, there has been growing concern that recent interest rate hikes may cause a step decline in this sector. However, this forecast assumes a more gradual decline for this sector, partially because mortgage interest rates are expected to rise only slowly. Specifically, the rate for existing-home mortgages is expected to rise from 5.7% in 2003 to 7.3% in 2008. While the latter rate is high compared to recent years, it is much lower than the 8% rate that prevailed in 2000. There should be a minor fallout from rising rates. National housing starts are forecast to decline from 1.9 million units in 2004 to 1.6 million units in 2008. The number of existing homes sold will fall by about one million during the forecast period, from 6.6 million units to 5.6 million units.